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Understanding Society

Artificial legal corporate entities

The (ab)use of letterbox companies

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Artificial legal corporate entities - The (ab)use of letterbox companies

1. Introduction

This short paper aims to introduce and summarise the state of the art with regard to the scientific and empirical knowledge on 'letterbox companies'. The broad spectrum of practices that are nowadays associated with the notion of letterbox companies has led to fact-finding, evidence based research and other scientific work from the angle of different disciplines (law, sociology, economics and political sciences). Even inside these disciplines there are separated (compartments of) activities, for instance related to tax law, corporate law or labour law, that deal with the issue. It is not the ambition to cover this vast area here. This multidisciplinary paper informs about the (possible) relationship between letterbox companies and practices that seem 'perfectly legal', but can be, not only from a moral point of view, dubious or unlawful.

The notion of letterbox companies is relatively of a recent date.¹ It was originally mainly used in the field of *taxation* and associated with (the evasion of) corporate and income tax. The use of this type of letterbox companies was assisted and promoted by trusts and company and legal services (often also the 'incubators' of these arrangements) that provided 'substance' and regulatory compliance. These facilitators earned vast sums from facilitating transactions for tax evasion and money laundering. The EU has reacted in the last ten years with discussions on the matter at the European Council. The decision was to formulate 30 concrete proposals for action against tax heavens and tax evasion (for example, the 'country by country reporting'). Also the European parliament became very active in this field.²

In the *labour and social security policy* areas the notion came up in the late 1990s in the international transport sector, based on dubious practices and problems caused by letterbox companies, which had only addresses in the country of establishment and all activities offshored to a different jurisdiction, often combined with 'bogus self-employment' among drivers and ignorance of statutory pay and working time rules.³

It was reintroduced at EU-level during the preparations of the *Services Directive* (2004) and in the debates about the necessity to promote decent work. The phenomenon became associated with a 'cheap labour business model': letterbox companies that operate in a cross-border context and pick and choose the social security and labour standards regime that is the most profitable. Ownership and employer liabilities are obscured or blurred by using proxy owners or henchmen. These entities take advantage of limited inspection competences and a lack of transnational enforcement mechanisms to deprive workers of their wages and contributions.⁴ In practice the cross-border recruitment prevents states from reinforcing

¹ In this paper the notion of letterbox companies is used for a company that has no or very little activity at the place where it is registered. Often, the same phenomenon is referred to with different names, for instance mailbox companies, brass-plate companies, shell companies or pro forma-companies.

² This 'fiscal engineering' is up till now the area that is mostly covered by the media (the Panama papers et cetera). But also the EU institutions are primarily looking at this area, see for instance:

<http://www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2013-205>
http://www.akeuropa.eu/en/european-parliament-debates-letterbox-companies.html?cmp_id=7&news_id=3015&vID=41

³ For example the Kralowetz-affair that ended with prison sentences: <http://paperjam.lu/communiquer/affaire-kralowetz-reaction-du-ministere-des-transport>

⁴ C-V. Martin, *Preventing illegal immigration: juggling economic imperatives, political risks and individual rights*, 2004, Council of Europe, Strasbourg. J. Cremers, *The free movement of workers in the European Union*, 2004, Brussels, CLR/Reed Business Information. J. Cremers, *In search of cheap labour*, 2009, Brussels, CLR/i-books.

employment and labour standards, or their circumvention through fake ownership and questionable labour relations.⁵

2. Definition of letterbox companies

The fact that specialists from several disciplines in the meantime started to examine and analyse the notion of letterbox companies from their perspectives resulted in different definitions depending on the perspective that was chosen. One of the basic definitions was provided by the OECD in its Model Tax Convention 2014, whereby a letterbox company is a paper company, shell company or money box company, i.e. a company which has compiled only with the bare essentials for organisation and registration in a particular country, whilst the actual commercial activities are carried out in another country.⁶ This definition has been taken over by most OECD-countries and refers in case of *tax evasion* to a business that establishes its domicile in a tax friendly country with just a mailing address while conducting its commercial activities in other countries for purposes of minimising its tax liability. Also the European Commission reasons in this direction by stating that 'letterbox subsidiaries' are artificial arrangements established in countries solely to qualify for a softer tax regime and cut their bill.⁷

The linkage with the *free provision of services* led, some 15 years ago, to a definition that went beyond taxation. In the debates, critics of the uncontrolled mobility of national service providers referred to the creation of letterbox companies offering services at low prices, which would be able to operate from their registered offices across the whole territory of the European Union. The consequence, it was feared, would be enormous pressure on countries with social, fiscal and environmental standards that protect the general interest.⁸ Interestingly, the European Commission referred in 2013 especially to legislative loopholes with a definition that said 'letterbox companies are companies which have been set up with the purpose of benefitting from legislative loopholes while not themselves providing any service to clients'.⁹

On a special website, targeting the abusive use of letterbox companies, the given definition speaks about a firm that is set up with the intention of circumventing *legal and conventional obligations*. Examples of these are taxation, social security, VAT, pay and pay related working conditions.¹⁰ These companies do not actually perform any real economic activities although claiming to do so. In a recent study, commissioned by the ETUC, the definition is focusing on a range of issues: a letterbox company is defined as a business that establishes its domicile in a given Member State while conducting its (substantial) activities in other Member States for purposes of circumventing or evading applicable legal obligations (lower taxes, wages, labour standards and social security contributions).¹¹

3. Regulatory frame for corporate mobility

The establishment of a company or subsidiary is covered by the freedom of establishment, as enshrined in Article 49 TFEU. Thus, in general terms, setting up a letterbox company in a

⁵ During the Dutch EU-presidency a large conference was organised with inspection services and other controlling institutions from the Member States. The agenda was partially dedicated to letterbox practices:

<https://www.inspectieszw.nl/decentwork/>

⁶ Also listed in the OECD-glossary of tax terms: <http://www.oecd.org/ctp/glossaryoftaxterms.htm#L>

⁷ European Commission, MEMO, Questions and Answers on the Parent Subsidiary Directive, 2013,

http://europa.eu/rapid/press-release_MEMO-13-1040_en.htm?locale=en

⁸ <https://www.eurofound.europa.eu/observatories/eurwork/articles/unions-protest-against-draft-eu-services-directive>

⁹ http://ec.europa.eu/smart-regulation/better_regulation/documents/1_en_act_part1_v4.pdf

¹⁰ <http://www.stopletterboxcompanies.eu/>

¹¹ <https://www.somo.nl/wp-content/uploads/2016/10/ETUC-report-annex-1.pdf>

foreign constituency is facilitated by that provision. Besides, companies benefit from the internal market principles that guarantee both the right of establishment and the freedom to provide services, cf. Articles 54 and 62 TFEU.¹² But it has to be understood that corporate entities are creatures of national law. The rules for setting up companies vary significantly among Member States. Some Member States traditionally follow the so-called real seat theory; the law governing a company is determined by the place where the central administration and substantial activities of that company are located. This requires companies having their operational headquarter within a given Member State to be established under the laws of that state. Other Member States follow the incorporation theory, which favours party autonomy in the choice of corporate law. Hence, under such law, companies may have their 'real seat' in a Member State different from the state of incorporation, which also implies that they may have a mere letterbox in the incorporation country. Companies can install a considerable part of their legal frameworks in other EU Member States without pursuing any activities there. Based on the freedom of establishment and the free provision of services these national entities are free to move around and get market access elsewhere in Europe.

In theory, a requirement can be imposed that companies with their seat situated inside the EU can only exercise the right of establishment and the freedom to provide services if their activity shows a real and continuous link with the economy of a Member State. The implication is that letterbox companies formed without any activities in the EU can neither rely completely on the right of establishment nor on the freedom to provide services (see section 5). But inside the EU, the conflict of legal provisions in labour law and company law can be used by companies which create artificial arrangements for the purpose of evading statutory and other obligations in the country of activity.

A report (from September 2016) of the European Parliament, dedicated to social dumping practices, asked to put an end to the letterbox companies by ensuring that businesses registered in EU Member States are genuine and active ones. The report suggested to tackle the phenomenon by the creation of a blacklist of European companies – including letterbox companies – who have committed serious violations of social legislation, as well as the creation of a European road transport agency to ensure a better co-operation between EU countries. And in fact, as regards the setting-up of an EU registration system for all companies, Directive 2012/17/EU establishes a system of interconnection of business registers which is currently being implemented and will be operational by mid-2017. However, national laws determine the way business registers are organised and the legal value of entries. The EU Council of Ministers so far has refused to work towards a central business register.

4. The genuine undertaking

In the EU acquis, some conditions are formulated that can serve to define the genuine undertaking. However, there is neither a unified integral and horizontal definition at EU-level, nor a comparable definition across the Member States, nor a definition in identical terms in the different policy areas at national and European level.

The most important notions are:

- in the field of taxation, the European Commission has tabled changes in the so-called Parent Subsidiary Directive, including a general anti-abuse rule, but this is restricted to tax transfers – an arrangement or a series of arrangements which, having been put into place for

¹² For a more detailed explanation see: <http://www.caymanfinancialreview.com/2016/01/28/letterbox-companies-in-the-eu/>

the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of this Directive, are not genuine having regard to all relevant facts and circumstances; the Directive says that Member States' tax administrations, when assessing whether an arrangement or a series of arrangements are abusive, should undertake an objective analysis of all relevant facts and circumstances; an arrangement or a series of arrangements shall be regarded as not genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality;

- the Regulations for the coordination of the social security (883/2004 and 2009/987) provide criteria for the assessment of the genuine character of an undertaking; Regulation 987/2009 Art 14. 2 says:

For the purposes of the application of Article 12(1) of the basic Regulation, the words 'which normally carries out its activities there' shall refer to an employer that ordinarily performs substantial activities, other than purely internal management activities, in the territory of the Member State in which it is established, taking account of all criteria characterising the activities carried out by the undertaking in question. The relevant criteria must be suited to the specific characteristics of each employer and the real nature of the activities carried out.

- the Regulation for the international transport (1071/2009) formulates criteria on access to the sector, with provisions to eliminate letterbox firms; for instance Article 3 prescribes that undertakings engaged in the occupation of road transport operator shall have an effective and stable establishment in a Member State; and Article 5 provides a list of conditions relating to the requirement of establishment:

In order to satisfy the requirement laid down in Article 3(1)(a), an undertaking shall, in the Member State concerned:

(a) have an establishment situated in that Member State with premises in which it keeps its core business documents, in particular its accounting documents, personnel management documents, documents containing data relating to driving time and rest and any other document to which the competent authority must have access in order to verify compliance with the conditions laid down in this Regulation. Member States may require that establishments on their territory also have other documents available at their premises at any time;

(b) once an authorisation is granted, have at its disposal one or more vehicles which are registered or otherwise put into circulation in conformity with the legislation of that Member State, whether those vehicles are wholly owned or, for example, held under a hire-purchase agreement or a hire or leasing contract;

(c) conduct effectively and continuously with the necessary administrative equipment its operations concerning the vehicles mentioned in point (b) and with the appropriate technical equipment and facilities at an operating centre situated in that Member State.

- the Enforcement Directive (2014/67/EU) for the posting of workers gives some guidelines in Article 4.2:

In order to determine whether an undertaking genuinely performs substantial activities, other than purely internal management and/or administrative activities, the competent authorities shall make an overall assessment of all factual elements characterising those activities...

Such elements may include in particular:

(a) the place where the undertaking has its registered office and administration, uses office space, pays taxes and social security contributions and, where applicable, in accordance with national law has a professional licence or is registered with the chambers of commerce or professional bodies;

(b) the place where posted workers are recruited and from which they are posted;

(c) the law applicable to the contracts concluded by the undertaking with its workers, on the one hand, and with its clients, on the other;

- (d) the place where the undertaking performs its substantial business activity and where it employs administrative staff;*
- (e) the number of contracts performed and/or the size of the turnover realised in the Member State of establishment, taking into account the specific situation of, inter alia, newly established undertakings and SMEs.*

5. Case law on artificial arrangements

In one case concerning VAT tax, the Court of Justice of the European Union has stated that the mere presence of a postal address may not be taken to be the place of establishment of a business of a taxable person. However, the settled CJEU case-law with regard to domestic measures targeting letterbox companies established in other Member States is more important. Measures that are likely 'to limit their freedom of establishment or their freedom to provide services' are not per se incompatible with EU law, but have to be justified by overriding reasons of public interest. And restrictions must be appropriate to attain the objective pursued and cannot go beyond what is necessary.

The overriding reasons of public interests, considered by the court, are mostly limited to the prevention of abusive tax practices, for instance in case of 'wholly artificial arrangements intended to escape the domestic tax normally payable'. According to the court, the finding that there is a wholly artificial arrangement must be based on objective factors which are ascertainable by third parties with regard, in particular, to the extent to which the controlled foreign company physically exists in terms of premises, staff and equipment. If checking those factors leads to the finding that the company is 'a fictitious establishment not carrying out any genuine economic activity in the territory of the host Member State', the creation of that company must be regarded as having the characteristics of an artificial arrangement. And the Court adds that this could be so in particular in the case of a 'letterbox' or 'front' subsidiary.¹³

On the other hand, the CJEU has ruled that a host state may not refuse recognition of the legal capacity of a company incorporated under the law of another Member State, even if that company does not pursue any economic activity in the latter state. This is seen as the start of a process of regulatory competition in the EU as, afterwards national reforms moved away from the real seat theory in laws governing the creation of companies. There is a clear lack of coherence regarding the choice of law rules in current EU regulations on the activities of supranational companies and the cross-border provision of services. In the end, the CJEU requires not only the elimination of all discrimination on grounds of nationality against providers of services established in another Member State, but also 'the abolition of any restriction, even if it applies to national providers of services'. This policy has eased the possibility for letterbox companies to be created through artificial arrangements in order to circumvent national mandatory rules and obligations.¹⁴

5. Some final observations.

Recent studies try to shed a light on the impact of letterbox companies on compliance with and respect for labour standards and social security obligations. The studies lead to the conclusion that the primacy to freedom of establishment and deregulation of company law that dominates the internal market can make letterbox-type practices legal under EU law. This creates serious tensions with the enforcement of labour, social security and tax laws.¹⁵

¹³ ECJ 15.3.2011, C-29/10, Koelzsch, ECR 2011 p. I-1595, ECLI:EU:C:2011:151.

¹⁴ K. Lenaerts, Self-employed and Europe: Small businesses and the freedom to provide services, 2011, European Journal of Law 1: 32-48.

¹⁵ Ibid note 11. Also M. Bernaciak, 2015, Market Expansion and Social Dumping in Europe, Routledge, London.

In the field of *taxation*, the regulatory context in the EU can be characterised by a lack of harmonisation as regards corporate and personal income taxes. The EU has restricted competences and each Member State has in principle the power to determine which companies are tax resident – generally subject to corporate tax on their worldwide income – in that state. The EU Treaty provides for tax provisions which aim at removing obstacles to intra-EU trade that result from the exercise of taxation powers by Member States. It is possible to prohibit Member States to establish or maintain obstacles to intra-Community movement and trade.

In the field of *social security*, the EU has also limited competences; form and content of the social security provisions and schemes belong to the competences of the individual Member State. The coordination of the different national schemes is based on the principle of application of one legislation at a time in cases of employment being executed in one or more than one Member State. Persons moving within the EU are thus subject to the social security scheme of only one Member State. The coordination has generated a substantial amount of jurisprudence, notably linked to the free movement of workers and cross-border recruitment.

One of the basic problems is that posting of workers in the frame of the *free provision of services* by foreign entities leads to exemption from the host land social security legislation. By the late 1980s, the first indications of the practice of bypassing the applicable rules through the use of foreign labour-only subcontractors led to questions related to the role of cross-border labour recruitment with reference to posting. Posting has become part of a matrix of complex, semi-legal and outright unlawful employment arrangements involving foreign corporate entities with questionable substance in the country of establishment. Letterbox companies are opened for the purpose of work abroad in one or more countries. The workers seem most often to be made to work under the direct supervision of the user undertaking, thus creating a situation of bogus subcontracting or illicit provision of manpower. The absence of genuine activities in the country of origin may be combined with repeated cross-border work, in other Member States on an (almost) permanent basis.

The regulatory framework related to the phenomenon is stretched over various national and EU policy areas, with non-coherent, contradictory or even conflicting rules in company, labour and contract law, internal market regulations, tax rulings and social security legislation. Silo-thinking leads to the application of different notions about lawfulness, regularity and the genuine character of activities and entities. Competences to test the genuine character of the activities are fragmented and spread over different national institutions. The dispersion and fragmentation of the competence to control and enforce make it difficult to monitor and combat abusive practices and the patchwork of regulations, combined with a lack of enhanced and straightforward cooperation beyond the limits of every separate policy area or discipline, hinders effective actions of inspections and other enforcement services. Moreover, less coherence means an increased risk of gaps or overlap and also legal complexity which hampers effective application of the law and therefore favours unreliable actors. Unnecessary contradictions or frictions between those areas of law should be avoided where effective prevention and combating letterbox companies require a consistent enforcement frame.

The signalled loopholes paved the way for firms and agencies that can be easily established in a foreign constituency, disappear across the border, go bankrupt and start all over again. It also has led to an advisory industry of incubators that can explain how ‘perfectly legal’ the course of action is. It is thus imperative to strengthen the legal framework and to repair loopholes and inconsistencies in a horizontal and coherent way. This in fact, asks for an impact assessment across a large part of the internal market acquis, not only with the aim to protect workers, but also in the interest of genuine economic actors and consumers.